PRI Principles for Responsible Investment

PRI RESPONSE TO THE FCA CONSULTATION ON THE EXTENSION OF THE REMIT OF INDEPENDENT GOVERNANCE COMMITTEES

ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. Originally set up by the UN in 2005, the PRI is now a not-for-profit company with over 2,350 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles globally with approximately US $86 trillion in assets under management. 366 of these signatories, representing $9 trillion, are based in the United Kingdom.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that ESG factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

SUMMARY OF THE PRI'S POSITION

The PRI welcomes the proposed expansion of the remit of Independent Governance Committees (IGCs) to include oversight of pension providers' policies and their implementation regarding material ESG issues, stewardship and member views. These considerations have a significant influence on the financial returns and impacts of investments made on beneficiaries' behalf. Oversight of these matters by an independent body required to protect members' interests is essential to reduce regulatory arbitrage and gaps in outcomes for savers in contract-based schemes compared with those in trust-based schemes.

As set out in an accompanying letter, the PRI is concerned that the different structures of and regulatory frameworks for IGCs and trustee boards reduces the likelihood that savers in contract-based schemes will be assured the same quality of outcomes as those in trust-based schemes.

While the FCA has largely sought to replicate the Department for Work and Pensions' (DWP) rules for IGCs, this does not account for differences in accountability, independence and composition for IGCs, as well as how they report on their activities. If these issues are not addressed, there is a risk that the reforms proposed here will not be effective in practice, particularly regarding the integration of member views.

Trustees are subject to a fiduciary duty and either make investment decisions internally or negotiate a mandate with an external manager, providing opportunities to integrate member views into investment strategy. Given the absence of comparable opportunities for contract-based schemes, it is reasonable to create a stronger imperative for providers to consider member views.

RECOMMENDATIONS FOR THE FCA

Regarding the questions posed in this consultation, the PRI recommends that the FCA:

1) **Provide guidance on reporting.** The FCA should improve reporting quality and comparability by providing guidance on what information the designated reporting body (either IGCs or providers) should include when reporting to beneficiaries.
2) **Require providers to consider member views.** The FCA should amend the proposed guidance to state that provider firms "should" consider member views, rather than that they may do so.

In addition, regarding broader concerns with the structure of and regulatory regime for IGCs, the PRI recommends the FCA:

1) **Regulate the activities of IGCs.** The FCA should monitor IGCs to ensure they are fulfilling their duties to members and that they are independent in practice. Sanctions and remedies should be put in place for when IGCs are not fulfilling their duties.
2) **Require providers to report to beneficiaries**. Providers should be designated as the primary reporting body, with IGCs evaluating the accuracy of this reporting and providing independent commentary on the adequacy of the provider's policies.

RESPONSE TO DETAILED QUESTIONS

The PRI's response will be confined to questions 1-5.

CONSULTATION QUESTIONS

Q1: Do you agree that IGCs should report on the adequacy and quality of their firm's policies on ESG issues, member concerns and stewardship?

The PRI supports expanding the remit of IGCs to include oversight of ESG issues, member concerns and stewardship. The PRI recommends that the provider, rather than the IGC, is designated as primarily responsible for reporting on these issues to beneficiaries, with IGCs providing oversight.

(i) Expanded remit

Independent oversight of the aforementioned issues by IGCs will reduce the potential divergence of outcomes between savers in contract-based schemes and those in trust-based schemes, given the importance of these issues for investment returns and that trustees are already subject to similar requirements.

ESG issues have a material effect on investment performance, particularly over the long-term. Despite this, integration of these issues into investors' strategies and decision-making has been inconsistent. Expanded oversight of these issues is likely to improve providers' consideration of these long-term value drivers.

Similarly, stewardship is one of the most effective strategies available to investors to minimise risks and maximise returns. Recent academic research commissioned by the PRI shows that successful engagement dialogue is not only correlated with positive returns on assets[1], but it also increases communication, learning and internal relationships for investors and companies.[2]

Stewardship can also enable pension beneficiaries to have a positive impact on society and the environment via their savings. By raising corporate awareness of environmental and social issues and by encouraging them to take effective action and to report on these issues, investors can encourage companies to minimise their negative impacts and maximise their positive contribution.

Regarding member views, the PRI encourages asset owners to regularly engage beneficiaries about their sustainability preferences and be transparent about their investment and ownership practices. The PRI has previously identified greater attention to beneficiary interests as one of nine key

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[1] https://www.unpri.org/academic-research/local-leads-backed-by-global-scale-the-drivers-of-successful-engagement/537.article

[2] https://www.unpri.org/academic-research/how-esg-engagement-creates-value-for-investors-and-companies/3054.article

conditions that must be addressed to achieve a more sustainable financial system.[3] This is of particular importance for savers in defined contribution schemes, who bear the risks of investment decisions made on their behalf.

(ii) Reporting body

As set out in the attached letter, pension providers are better-placed to report on policies and implementation regarding ESG, stewardship and member views. The IGC could oversee the quality of the providers' reporting, recommend changes and include independent commentary on the sufficiency of the provider's policies and activities.

IGCs' role is to ensure that providers are acting in beneficiaries' best interests. They are not actively involved in the design of default investment strategies or policies around ESG integration and stewardship. Shifting the onus for reporting to the provider will ensure that the body which participated in investment decisions is responsible for explaining them, and will free up the IGC's time to focus on their crucial oversight role.

Q2: Do you agree that IGCs should report on how the firm has implemented its policies on ESG issues, member concerns and stewardship?

Yes. The provider's performance in this regard should be measured in terms of the outcomes achieved rather than solely the quality of their policies. A focus on outcomes would ensure that annual reporting sets out where a provider has generated value or positive impacts and would prevent a reliance on standard language which can be replicated year-on-year.

Q3: Do you agree that IGCs should report on the firm's policies on these issues for both pathway solutions and workplace personal pensions?

Yes. ESG issues can be material over a variety of time horizons; as such it is appropriate that the IGCs monitor the adequacy of the providers' policies on these issues for pathway solutions.

Q4: Do you agree that firms should make the IGC's annual report publicly and prominently available, with 2 prior year reports for comparison?

Yes, though as noted above the PRI recommends that responsibility for preparing an annual report should reside primarily with the pension provider.

Q5: Do you agree that the proposed guidance should apply more widely, to all firms that provide pension products and all life insurers that provide investment-based life insurance products?

[3] https://www.unpri.org/sustainable-financial-system/how-the-pri-is-contributing-to-a-sustainable-financial-system/199.article

Yes. The PRI recommends that the proposed guidance state that firms “should”, rather than “may”, take member views into account in the event that the two-step test is met. The PRI further recommends that the FCA provide greater guidance on how information to beneficiaries should be reported, as well as guidance for reporting on climate change-related risks and opportunities.

(i) Member views

To account for the differences between trustee boards and IGCs, the FCA’s guidance should more prescriptively call for the integration of member views into investment strategy.

Trustee boards either manage assets internally or negotiate investment mandates with asset managers, and thus have an opportunity and bargaining power to ensure that matters of importance to beneficiaries are conveyed and integrated into investment strategies. No comparable opportunity arises for contact-based savers. Given many employers’ lack of engagement with employee pension investments[4], and the limited powers of IGCs, providers are not incentivised to incorporate member views in the absence of stronger guidance.

Investment risks also affect these two legal structures differently. The majority of trust-based pension assets in the UK are held under defined benefit schemes, where it is the plan sponsor that bears the investment risk. However, contract-based pensions are exclusively defined contribution schemes, where the risk resides with the beneficiary, and as such it is of particular importance that these members’ preferences are taken into account.

In addition, while a significant number of trustee boards contain representatives of scheme members, despite the FCA’s efforts to encourage member representation on IGCs, a ShareAction report last year found that only one IGC contained a member representative.[5]

Given these distinctions, a different regulatory approach is called for. While an optional integration of member views may be appropriate for pensions trusts where there are existing incentives for that option to be exercised, members of contract-based schemes are unlikely to see their views integrated without regulatory intervention, despite the increased importance within this context.

It is worth noting that integration of beneficiaries’ sustainability preferences does not necessarily entail undertaking member surveys. As the Law Commission[6] and The Pensions Regulator[7] have pointed out, it is possible to make assumptions. Such assumptions may be based on, for example, public opinion data and an understanding of the profile of the average scheme member. What is appropriate and proportionate for each scheme will vary depending on their size and resources; however all schemes should be able to take measures to ensure investments are in line with the best interests and preferences of their specific beneficiaries.

[4] Office of Fair Trading (2013) – *Defined contribution workplace pension study*.
[5] https://shareaction.org/wp-content/uploads/2018/02/PolicyReport-IGCRanking.pdf
[6] https://www.lawcom.gov.uk/project/pension-funds-and-social-investment/
[7] https://www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/6-communicating-and-reporting

(ii) Increased clarity

The FCA should provide guidance to providers/IGCs to ensure reporting to beneficiaries is clear, straightforward and comparable between providers.

Given that pension beneficiaries vary widely in their financial literacy and levels of engagement, it is important that reports prepared for their consumption give prominence to key information that all beneficiaries should know, are written in plain English and are as short as possible while remaining meaningful.

In general, these standards do not appear to be met under current reporting. The aforementioned ShareAction report found that several IGC reports omitted key information on provider charges and competitiveness. Reports also tend to be lengthy, some running over 50 pages; these are unlikely to be useful to beneficiaries with limited time. With the proposed expansion of the content of IGC reports to include ESG issues, this length and complexity is only likely to increase.

Dedicated guidance from the FCA could facilitate a higher quality reporting environment. Such guidance could identify the key information that reports should highlight to beneficiaries and improve the comparability of costs and ESG outcomes that different providers achieve. This guidance could also suggest more commonly understood terms over technical ones - for example, a recent survey[8] found that “ESG” was an unpopular term among DC members, with “Responsible investment” the preferred option.

(iii) Climate change

Climate change will affect all sectors of the economy in all geographies. Both companies and investors are increasingly expected to report on the financial impacts of climate change on their business, in line with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD). To this end, the Department for Work and Pensions (DWP) has brought together a working group to develop guidance for pensions on how to report on TCFD.

Given that, on average, the time horizons for beneficiaries of contract-based schemes tend to be longer than their trust-based counterparts', it is particularly important that the financial impacts of climate change on their pensions is well understood. To that end, the FCA should either ensure that the DWP's guidance can apply equally to contract-based pensions, or work with this group to provide similar guidance for pension provider firms.

Any questions or comments can be sent to policy@unpri.org .

[8] https://www.ipe.com/news/esg/should-dc-schemes-drop-the-term-esg/10031584.article .